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## Japan, the Reluctant Reformer

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### Abstract:

*For years the Japanese have weathered their country's ongoing recession with apparent stoicism. In fact, however, Japan's citizens have learned to find private solutions to their country's many ills, just as Japanese corporations have moved more and more of their operations overseas. But this trend has only driven Japan into deeper economic straits. If the country's charismatic new leader cannot push through fundamental reforms, capital flight and emigration could be the public's next moves.*

### Full Text:

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### TOO MUCH OF A BAD THING

At the end of last year, Japan's citizens, having struggled for years with a bitter recession, were hit with still more bad news: another arbiter of international opinion had forecast their country's imminent decline. In its Global Trends 2015 report, the CIA predicted that, in view of China's ongoing rise, Japan "will have difficulty maintaining its current position as the world's third largest economy [after the United States and Europe]." Just a few months earlier, Japanese bonds had been demoted for the second consecutive time by Moody's, the U.S. credit-rating agency. After long enjoying Moody's highest rating, Japan's credit was now judged to be as risky as Portugal's.

Both stories made big news in Japan, as did the underlying problems that provoked such negative appraisals in the first place. Yet despite the widespread attention these economic woes received, the Japanese public remained strangely quiescent. This resignation has become a typical response to the ailing economy. Voters keep returning the long-dominant Liberal Democratic Party (LDP) to power, although it has presided over a decade of stagnant growth and sunk the government deep into debt. Japanese investors accept interest rates of less than one percent on their savings accounts, labor unions swallow pay cuts, and the business community watches meekly as the government's attempts to end the financial crisis fail to revive the nation's banks or alleviate the credit crunch.

Now Junichiro Koizumi, a "reformist" who became prime minister in April after the LDP elected him party leader, may finally break this pattern of resignation in the face of decline. But Koizumi's recent popularity should not be mistaken for a genuine, broad-based reform movement. The public appreciates the new prime minister's competence and openness, especially in contrast to the bungling and aloofness of his predecessor, Yoshiro Mori. And Koizumi has scored points by criticizing his party's habit of funneling subsidies to inefficient but well-connected sectors of the economy, such as public-works contractors. But public support for the kind of specific, painful reforms needed for Japan to turn its economy around remains only skin deep. Koizumi may manage to convert Japan's vague desire for change into the political capital he needs to overcome opposition within the LDP. But if instead he succumbs to the forces urging further delay, the Japanese public could just as quickly abandon him.

This points to a deeper question: Why have the Japanese put up with stagnation for so long? Why have they not demanded that their government do something to revive the economy and head off the national decline? After all, this is a society famous for facing dire challenges head-on. When American "black ships" forced Japan to accept unequal treaties in 1858, the country fought back by adopting reforms that catapulted it into the ranks of the great powers in less than 50 years. And after its devastating defeat in World War II, the country reinvented itself so effectively that just a few years ago it seemed poised to economically outpace the United States. What has happened this time? Where is the passion and energy that propelled Japan's earlier reform campaigns?

The answer lies, ironically, in Japan's very success. For the first time in the country's history, individuals and firms now have the wealth and freedom necessary to pursue private solutions to their economic problems -- solutions that make perfect sense from an individual or corporate perspective but that actually aggravate economic problems at the national level. In the past, the Japanese were always too poor to pursue individual solutions to economic problems and thus relied on the state to harness their group efforts. Given this dependence on government, Japanese citizens had strong incentives to make their voices heard, ensuring that the state adopted wise policies that avoided debt and the kind of economic interventions that have now produced long-term inefficiency.

In the past, moreover, the self-help solutions available to struggling individuals and firms were much more constrained than they are today. International capital movement was tightly regulated, making it difficult to invest abroad. Conservative social norms limited career choices, especially for women, dictating that they eventually marry, leave their jobs, and have children. Today, however, highly educated Japanese women have the opportunity to hold well-paying jobs and to opt out of marriage altogether.

Thanks to today's greater freedoms and the financial ability to take advantage of them, the Japanese public has become more likely to try to escape the nation's problems rather than force the government to address them. The country's citizens seem convinced that it is better to use the "exit" option -- that is, to try to improve their own lot individually -- than to try to change government policy through political mobilization. Unfortunately, this trend has simply exacerbated economic problems at the national level, leaving the government with the huge task of paying off the massive government debt while trying to break the deflationary spiral and cope with low birth rates and a corresponding fall in the number of workers.

Now Koizumi has a chance to redirect the country's energies, helping Japanese citizens and companies make their complaints heard through the political process. But he will have to seize it quickly -- for if Japan's leaders lose the confidence of their people yet again, the public is likely to turn to even more radical exit options, such as capital flight and emigration.

## THE TROUBLES WITH TOKYO

From 1956 to 1973, the Japanese economy grew at the spectacular rate of almost 10 percent a year. This growth continued, at a still respectable 3.8 percent, until 1991. Since then, however, Japan has suffered two outright recessions and managed to expand its economy a paltry 0.96 percent a year. In an effort to propel the economy out of these doldrums, the government has nationalized and recapitalized banks, used government guarantees to keep credit flowing to small businesses, and piled one fiscal stimulus package on top of another -- pushing the Japanese state's debt to 666 trillion (\$5.6 trillion), or 130 percent of GDP. If things continue at the current rate, this debt ratio will reach an unprecedented 150 percent within the next three years -- even if Koizumi fulfills his aim of capping new government bond issuance at "just" 30 trillion (\$250 billion) a year.

Despite Tokyo's efforts and the massive outlay of cash, meanwhile, Japan's fundamental economic problems

remain unaddressed. The country's banks still sit on bad loans totaling at least 32 trillion (\$266 billion), with more credit going sour each year -- despite the fact that the banks have already written off the equivalent of twice their entire capital base and reserves over the past decade. Nor do they seem to have learned any lessons: with a few exceptions, most Japanese banks still continue to extend new loans to debt-burdened companies, often in exchange for only modest restructuring plans. Propping up so many weak firms has delayed the sort of structural adjustment that the country needs to eliminate its surplus capacity and allow the strongest firms to grow. And by keeping alive "zombie" firms desperate to sell surplus product at any price, the banks have helped push prices down for two consecutive years -- a development that makes it even more difficult for firms to become profitable again. This deflation also means the government cannot count on inflation to whittle away its own huge debt.

Thus far, Tokyo has managed to avoid paying a high price for its profligacy. The government gets the extra cash it needs from Japanese banks, life insurers, and the many individuals who still prefer to park their money in government securities. As a consequence of such investment, the interest rate on ten-year government bonds stayed near 1.75 percent last year and interest payments cost a manageable 26 percent of the central budget. Most government spending, however, has gone to keep inefficient public-works contractors on life support, even as the flow of cash from banks to small businesses -- including the high-tech start-ups that hold the key to the nation's economic recovery -- has slowed to a trickle.

To break its irresponsible spending habits, Japan needs to discipline the use of its economic resources. Public and private debt would not be such a problem, for example, if it were used to fund investments that would make the economy more efficient. But so far the returns on Japanese investments have been abysmally low by international standards, severely limiting the country's growth.

Assuring that its resources are invested productively is especially critical for Japan today because the nation faces a sharp decline in the size of its labor force and a sharp rise in the number of its elderly citizens. After growing steadily for five decades, Japan's working population has now begun to shrink, a few years ahead of 2007, when postwar baby boomers will begin to turn 60 and retire. Once they do, the country's working population will drop more quickly. In fact, the number of adults in the work force is expected to decline 13.3 percent by 2025. Increased immigration could slow this diminution. But the United Nations has estimated that Japan would have to absorb 700,000 new immigrants a year for the next 50 years to fully offset the shrinkage of its work force -- a rate inconceivable for a country that has no history of accommodating newcomers. Japan thus seems destined to see its ratio of working-age adults to retirees worsen dramatically, from 4:1 today to just 2:1 in 2025.

No nation has ever aged this rapidly. Even the United States, for all its warnings about an impending Social Security and Medicare crunch, is expected to reach 2025 with 3.25 working-age adults for every retiree. Japan, on the other hand, is facing a true crisis. Pensions and medical expenses for the elderly could push the share of government and social-insurance spending in the economy from 40 percent today to more than 60 percent by 2025. Uncertainty about how Japan will finance this burden, given that its government is already deep in debt, was the major reason that both the CIA and Moody's painted such pessimistic pictures of the country's economic health.

To combat the imminent contraction of its working-age population, Japan should do everything it can to make it easier for the one group that has been underrepresented in its paid labor force -- women with children -- to continue working. Only half of working-age Japanese women currently hold paying jobs, and the proportion is even lower for mothers. Many of these women look at Japan's employment system -- which offers limited child care, inadequate parental leave, inflexible schedules, and long hours -- and choose work or children, not both. By taking themselves out of the labor force, however, those who opt to be full-time housewives deprive the economy of their paid labor, making it harder for Japan to finance the baby boomers' upcoming retirement. At the same time, those who choose work and put off or opt out of marriage and children contribute to the country's shrinking birth rate. Indeed, in 1999, the country's total fertility rate fell to 1.34 children per woman of child-bearing age, a record low. If Japan is to cope with the aging of its population, it needs many more women to choose both work and children. But creating the sort of environment that will allow them to do so will require expanded government programs and changes in the attitudes of employers, schools, and husbands -- changes that most Japanese have not even begun to contemplate.

## EYES WIDE SHUT

In the face of so many problems, it is tempting to attribute the passivity of the Japanese public to the complexity

of the challenges they face or the fact that many of the economic consequences, although imminent, have yet to affect people's lives. Japan's unemployment rate remains below five percent -- high for that country but far below the rates found in most industrialized nations. Job losses, moreover, have mostly affected older and younger workers, women, and those employed by small and medium-sized enterprises. The core male work force, employed by large firms and the state, remains protected by lifetime employment guarantees.

The problems Japan faces are indeed mind-numbingly complex. It is not hard to understand why Japanese citizens might hear each of the various woes described -- including the size of the government's debt, low productivity growth, and the nation's rapid aging -- and still fail to figure out how they fit together or what they imply for their own families' economic future.

Yet the Japanese have been bombarded with economic analyses that make the personal implications of these problems quite clear. The Ministry of International Trade and Industry (MITI) has publicly predicted that if Japan retains its current policies, the nation's economy will grow at just 0.7 percent a year over the next ten years and shrink 0.2 percent a year between 2010 and 2025. Because paying for aging baby boomers will require an increase in taxes, MITI explained, real incomes will decline throughout the period, by 0.3 percent in the first ten years and by 2.2 percent yearly after that. Unless the government raises taxes and social security contribution rates or cuts benefits, Japan's debt could reach 200 percent of GDP in 2010 and 400 percent in 2025.

Meanwhile, the Japanese press has been doing its part to make the implications of these figures even more dramatic. On January 20, for example, the respected magazine *Toyo Keizai* featured a cover story headlined "A Chain of Bad Dreams"; an illustration showed a large bomb with a lit fuse and a ticking clock approaching the midnight hour. And news of this type seems to be sinking in. A 1998 government survey found that 73 percent of Japanese citizens over the age of 20 are concerned about their lives in old age, a sharp increase over similar polls conducted just a decade earlier. Another survey found that when working-age citizens are asked how confident they are in the future of the social security system, 60 percent answer "very worried."

## HEADED FOR THE DOOR

In the past, when Japanese citizens faced equivalent worries -- whether it was the challenge of the black ships or devastation in war -- they turned to the state for help. They did not do so because they naturally submit to authority or love their bureaucrats. In fact, the nation has a long history of peasant rebellions and tax revolts. Even as many Europeans turned to their governments to nationalize entire sectors of the economy after World War II, there was never much support for such a strategy inside Japan, where industry remained in private hands.

Yet when Japan struggled to recover from the devastation of the war, its citizens found themselves forced to rely heavily on their government. Short of funds and technology, Japanese industry needed the state's help in order to achieve the economies of scale that would allow it to compete in international markets. Tokyo was called on to provide necessary capital and to contribute indirectly by propping up a system of banks that could extend massive loans without worrying about bankruptcy. The state also helped out by regulating market entry and managing cartels so as to assure that leading firms in each sector were able to expand steadily without having to worry about excess capacity. By allowing the country to rapidly expand its production of energy, petrochemicals, steel, and other basic materials, the state thus laid the basis for the Japanese "miracle."

In his pioneering work on how organizations respond to decline, the economist Albert Hirschman distinguished between pressures for change that stem from disgruntled clients going elsewhere ("exit") and those that come from clients making their grievances known and trying to work within the system ("voice"). Some organizations, such as firms operating in competitive markets, are designed to respond to exit pressures: when customers stop buying a company's products, profits start to fall and the market forces that company to improve or else go out of business. Other organizations, such as public school systems, have traditionally been designed to respond to voices, such as the input of concerned parents. When these latter organizations work well, as they do in most American suburban communities, they do so because local educational authorities have well-established channels of communication with parents, who have high expectations of their schools and keep those authorities informed about problems.

Because the organizational structure that Japan developed over the postwar years was built during a time when Japanese firms and individuals had few options other than to rely on the state, it was more similar to an ideal suburban school system than an ideal market. The state developed excellent channels of communication with business that were enhanced as retired bureaucrats took on top positions in firms and private industry

associations helped implement policy. At the same time, corporations heavily dependent on state help had every incentive to keep channels of communication open from their end. What distinguished this system from planned economies elsewhere (and helped it avoid their inevitable fate) was the fact that firms remained in private hands. Needing to develop real competitive strengths, especially if they hoped to succeed in international markets, Japanese companies made sure government policy did not stray too far from the dictates of the market.

In time, however, Japanese industry became wealthy enough that many corporations no longer needed to depend on the state. Japan's most internationally competitive firms, such as Toyota and Sony, have for some years financed most of their investments out of retained earnings. They certainly do not need to rely on state financing, and they do not even depend on Japanese capital markets. When they need to raise external funds, they can turn to New York, London, or any number of other financial centers. This means that the most competitive segment of Japanese industry no longer has much incentive to make sure that the country's financial system remains efficient. Even if Japan's banking system seizes up, these firms can go abroad to raise the money they need.

Similarly, the liberalization of Japanese rules on capital exports and the increased globalization of Japanese firms have given rich companies additional opportunities to avoid problematic government policies. When labor-market regulations keep wages too high in Japan, rich Japanese firms can relocate their operations abroad. Likewise, when Tokyo's macroeconomic policies let domestic demand stagnate, Japanese corporations can still sell to booming markets elsewhere.

The wealth that has opened up new exit opportunities for Japan's industries has done the same thing for its citizens. Twenty years ago, few Japanese families had the resources to support their children once they reached working or marrying age. Young men left home as soon as possible and found a corporate job, whereas women married at a young age and went to live with their husbands. Social norms reinforced what was for many a financial necessity. In contrast, today many parents earn wages generous enough to support or subsidize adult children who remain at home. Fewer sons or daughters face financial pressure to marry, and some do not even feel much obligation to go to work. Social norms have changed too, with the Japanese becoming much more tolerant of women marrying later or not at all. These shifts have opened up previously nonexistent exit opportunities for young people who want to postpone or opt out of marriage or parenthood.

## A RACE TO THE EXITS

There are obviously good reasons to welcome the greater wealth and freedom that allow Japanese individuals and firms more choices. Nevertheless, the increasing availability of exit options across a wide range of socioeconomic institutions has created problems for a system that has long been organized around the exercise of voice. As Hirschman warned, organizations designed to respond to voice typically perform poorly when confronted by exit. Public school systems, for example, typically pay little attention when parents start taking their children out and moving them to other districts or private schools. Those parents who leave tend to be those with the highest expectations, so their departure actually relieves harried bureaucrats of the hassle of responding. Over time, however, these organizations descend into mediocrity. As more and more parents with high expectations leave, schools are left with only the most complacent. Exit continues until the problems become so bad that radical action is required: perhaps a state takeover or even the introduction of a voucher system.

Since its "bubble economy" imploded a decade ago, Japan has been caught in just such a dynamic. Faced with a host of economic problems, most Japanese have responded by racing for the exits rather than by raising their voices. Large Japanese corporations have led the exodus. As early as 1986, Japanese firms were already raising more than half of their capital abroad. These corporations also began moving more of their operations outside the country. Since 1980, Japanese companies have gone from being among the least transnational to enjoying, according to economists Keith Cowling and Philip Tomlinson, "the highest rate of overseas physical investment in the world." Honda and Sony, among the most international of Japan's firms, now have approximately 60 percent of their physical assets abroad, and Toyota has 40 percent. All of these companies now manufacture more than half of their products overseas (or plan to do so soon) and rely on foreign markets for a substantial share of their sales.

With the most competitive of Japan's firms reducing their dependence on the Japanese market -- not to mention Japanese capital, workers, parts, and services -- it is no wonder that the government's economic policy has veered so far from what the market demands. Whereas Japanese firms once all found themselves in the same boat and so had every incentive to make sure that their collective ship did not sink, today the most competitive

firms have their own boats. And they have allowed the remaining crew -- the firms that cannot compete and that need the state to survive -- to take control in Tokyo. These latter firms still participate in the system and exercise their "voices." But what such struggling corporations ask for is a bailout by the state, even though they have little prospect of returning to profitability and represent industries burdened with excess capacity.

Individual Japanese citizens planning for their retirement have also started to look for exits. Under the country's national pension system, Japanese who do not work can avoid paying into the program (although they are technically required to do so). An increasing number of such individuals -- including a quarter of all Japanese in their twenties -- have stopped contributing, doubting that the pension program will ever pay them back anything near what they would put into it. Such doubts are well founded. The news that corporate pension funds as a whole may be underfunded by up to 80 trillion (15 percent of GDP) has been widely reported, as have details of problems at specific firms. The national pension system for the self-employed and for dependent spouses suffers from huge unfunded liabilities as well.

In the face of such revelations, many Japanese have quietly begun to prepare for retirement by boosting their private savings. Such savings have increased steadily over the past several years. But with returns on ten-year government bonds (one of the most popular saving instruments) running at less than two percent, individuals have had to put away ever larger portions of every paycheck.

One would expect that Japanese pensioners and all those planning for their retirement would demand financial reforms to boost returns on their investments. After all, between 1990 and 1998, net interest payments -- the money on which retirees and savers depend -- fell from 8.5 percent of GDP to 4.4 percent. Instead of protesting, however, Japanese citizens have seemed content merely to make up for the lost interest income by saving even more -- although some have begun to exit from the problematic situation by shifting their funds into dollar accounts that pay much higher interest rates.

The final group that has chosen to exit the system rather than rise up in protest has been young women. Most Japanese women continue to tell pollsters that they want to marry and have at least two children. Many young women also report that they enjoy working and earning their own incomes. Faced with an environment that makes it very difficult to combine career with family, however, most of these women end up choosing between the two options rather than fighting for the kind of far-reaching social and political changes that would make combining them more practical.

The increase in Japanese family wealth has enabled more and more women, as well as their potential husbands, to remain single and continue living with their parents. But this trend, combined with an increase in the number of women who ultimately choose a career over marriage, has caused the proportion of women in their late twenties who have never married to surge from just 18 percent in 1970 to 48 percent in 1995 (the most recent year for which statistics are available). The proportion of never-marrieds in their thirties also increased sharply, with 20 percent of women in their early thirties remaining unmarried in 1995.

This trend toward delaying or opting out of marriage altogether is the main reason fertility rates are now so low in Japan. Although the government's population projections continue to assume that fertility will recover, some Japanese researchers point to Tokyo's extremely low fertility rate -- only one child per woman of child-bearing age -- and predict that it is just a matter of time before the national rate drops that low. If it does, Japan will have even more difficulty financing the upcoming retirement of its baby boomers.

#### THE KOIZUMI QUESTION

Just as the departure of insistent parents from public schools can speed such systems' decline, the uncoordinated exit of Japanese firms and individuals has only made the nation's long-term economic problems worse. Decisions by Honda and Sony to locate their high-return investment projects abroad end up channeling Japanese capital into much less efficient investments. Similarly, by increasing their private savings to make up for possible cuts in pension benefits, individual Japanese have made it more difficult for the government to get the economy back on track by boosting consumption. Finally, by deciding to leave the work force or delay marriage, Japanese women have made it even more difficult to manage the country's looming demographic crunch.

Were any of these trends occurring in isolation, Japan might be able to wait for them to reach crisis proportions and prompt radical solutions. In fact, however, the problems are intertwined. As further decline in the fertility rate

increases worries about the stability of the pension system, individuals desperately try to save even more and spend less. As the nation's most competitive firms invest more abroad, the rate of return on capital invested with those firms that remain drops even lower. Both of these trends make it even more difficult for the government to keep the economy afloat, increasing the likelihood of a bond-market crash and hyperinflation. The fear of such a possibility leads firms, individual investors, and women to look for more radical exit solutions, such as capital flight and emigration.

Only one path leads out of this exit spiral. Japan's political leaders must inspire the country's citizens to redirect their energies inward, toward domestic reform. So far such inspiration has been conspicuously absent. Japan's bureaucrats have lost the public's confidence by mismanaging the economy for a decade. And because real reform will be painful, generating bankruptcies, job insecurity, and difficult changes in gender roles, few politicians have dared to suggest it.

Enter Koizumi, who promised to buck this trend. Campaigning for the job of LDP party leader in April, Koizumi announced his support for "structural reform with no sacred cows." He warned the public to prepare for up to two years of slow or even negative growth. Koizumi promised to cap the creation of new government debt and to push the banks into disposing of their bad loans within two or three years -- steps that, if carried out faithfully, will cut off the life-support system that has allowed weak firms and inefficient sectors to avoid painful restructuring. In his first weeks in office, the prime minister also promised to eliminate waiting lists for child care to enable more women to combine careers and motherhood. Such reforms have made him wildly popular with the general public, earning him approval ratings as high as 87 percent.

Koizumi knows, however, that it is easier to call for reform than to push it through. He became prime minister on the strength of his popularity with the public, not his support in parliament. Many LDP members of the Diet remain unenthusiastic about Koizumi's proposed reforms, which would hurt their supporters in the inefficient construction industry and other protected sectors of the economy. Having used him to improve the party's electoral chances in the upper house, these LDP "traditionalists" -- many of them in the long-dominant Hashimoto faction that has been marginalized since Koizumi took over -- are likely to use every opportunity to delay and sabotage his initiatives. To avoid this risk, Koizumi may have to create an open split in the party, calling an early election for the lower house and allowing only those who support him to run under the LDP banner.

This tactic would be risky. The public may heed Koizumi's call to arms and answer his request -- made during a campaign commercial -- for help in wedging a lever under the giant rock of Japan's status quo. If real reforms restore public trust in the pension system, give young couples enough confidence in their financial security to risk marrying and having children, and convince leading firms to reinvest in the country, then the nation may finally escape its economic doldrums.

But if Japanese voters come to feel that their trust has been betrayed and that they were fooled into returning to power a party that cannot cut its ties to protected interests, the backlash could be severe. Japan's citizens will return to exit strategies with renewed vigor. The country will still need to change its ways eventually, since Japan cannot go on adding \$250 billion a year to its government debt while experiencing deflation. But exit-driven reform would be the most painful option, far more wrenching than the alternative available now: restoring public trust in Tokyo's ability to safeguard its economy and look after its own citizens.

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